School for Traders & Investors

Fifty-Second Lesson

Explaining the Stock Market Cycle

Showing the Intimate Relation Between Money Rates and Security Movements

WE believe that the average student of the stock market should broaden his general knowledge of the more important fundamental statistics, as a foundation for his studies of detail with regard to price movements of individual representative securities and speculative stocks. With this idea in view, a further discussion of the subject of money rates and their general relationship to the stock market is in order.

Among the important barometers of business are bank clearings, loans and deposits, and money rates. Aggregate bank clearings of the United States, whether plotted on a weekly, monthly or annual basis, show a gradual increase from year to year for many decades. This increase is a natural reflection of the continuous increase in the volume of the country's business, and is therefore a measure of the country's growth. If the clearings are plotted weekly or monthly, the resulting graph shows an irregular, saw-toothed line, whose average trend is regularly upward. The general inclination of the line indicates the country's business expansion, while the saw-tooth variations, above and below its average inclination, is in synchronism with the alternate waves of business prosperity and depression from cycle to cycle.

A study of these figures has shown that their interpretation is more significant if they are separated by subtracting from the total clearings the clearings outside of New York, thus leaving the clearings originating in New York for separate investigation. If now we plot both sets of figures we find that the clearings outside New York show a comparatively regular saw-tooth line representing the normal business growth of the country, from which many of its more speculative elements have been eliminated. The curve of New York clearings, on the other hand, is more irregular, with saw-teeth much larger. The reason for this is that the business represented by the New York clearings is less conservative, and includes a large percentage of highly speculative transactions, especially those relating to the country's most important stock markets, and many of the leading commodity markets.

Further analysis of these more speculative clearings shows that when they are rising rapidly, during the process of discounting increasing business prosperity, capital is passing rapidly into speculative stocks and bonds. When this process has proceeded to the extent that New York clearings are abnormal as compared to the average trend of the same figures over a period of many years, then an atmosphere of financial stress has developed, business optimism has probably been overworked, fixation of capital has gone beyond safe limits, and business inflation has undermined credit structures.

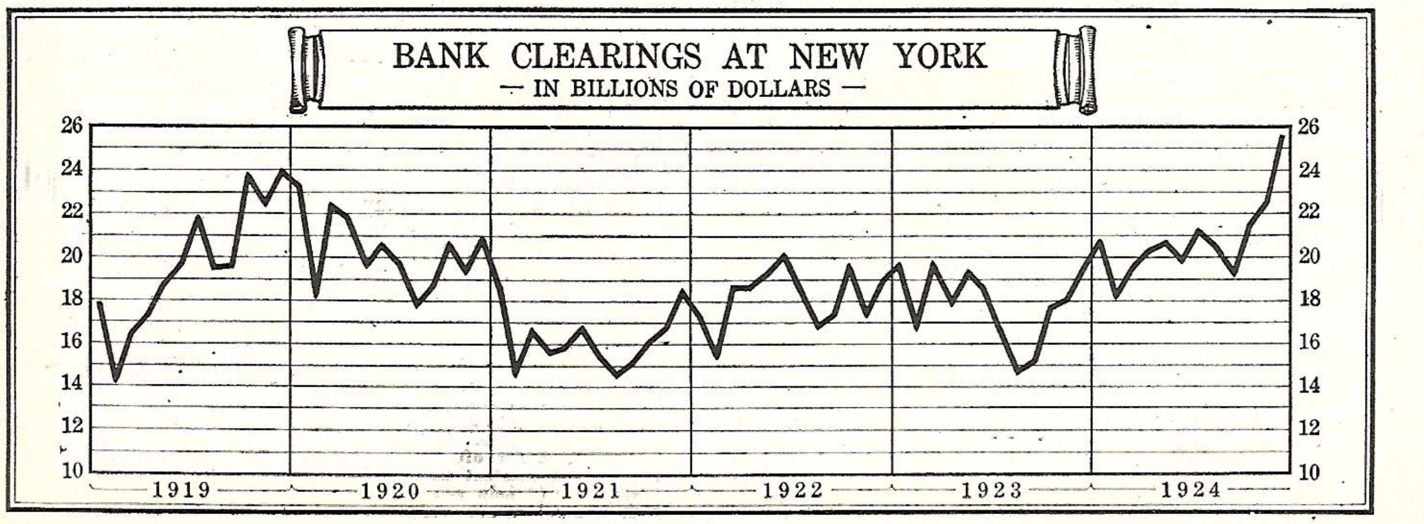
We now have most of the conditions necessary for a crash, and under such circumstances, when New York Clearing House loans exceed deposits, this ultimate strain needs only to be followed by some sudden unfavorable news to precipitate a break, usually characterized by complete reversal of public confidence and a flood of liquidation of speculative holdings.

With this as a background for a study of the relationship of money rates to the stock market cycle, it will be of interest to trace this relationship through one complete ordinary cycle of the market and general business.

A Typical Example

Suppose we begin with the stock market at the bottom. The average price of a large number of representative stocks has reached its low level. Business depression has been completely discounted, all the bad news is out, and the market is in a sold-out condition. Those traders and important financial interests who understand the situation are accumulating

(*Please turn to page* 798)



(*Continued from page* 796)

proceeded to write up depreciation and depletion to the limit allowed by law. The result worked havoc in net earnings available for dividends. Investors saw the anomaly of company paying substantial dividends which apparently had not been earned. Had there been no depletion charges dividends would have been easily earned in many instancs.

It is not the purpose of this article to enter into an extended discussion of the basis for mining depletion charges. The subject is extremely involved and there is much diversity of opinion in regard to it. The theory of mining depletion calls for the charging off each year enough so that, when the mine is exhausted, its cost will have written down to zero. There is great difficulty in putting this theory in actual practice for reasons already indicated. The law allows three bases for determining cost, 1) the actual cost of the property in dollars, 2) its so-called "discovery" values as determined within 30 days after the date of discovery, and 3) the value of the property as of March 1, 1913. The third method applies only to properties in operation prior to that date. The usual method is to figure on the actual cost of the property.

In the accompanying tabulation there appears a wide diversity in depreciation and depletion charges. Cerro de Pasco, for instance, charged off approximately $6,271,000 in 1923 for depreciation and depletion, of which about $2,271,000 was for depreciation and approximately $4,000,000 was for depletion. Nevada Consolidated, on the other hand, charged off approximately $526,000 for depreciation and nothing for depletion. It is obvious that such wide differences in accounting practice are inevitable in view of the great differences existent between various mining properties. In the case of companies which do not include depletion charges in the earnings statements, it may be safely assumed that such charges are included in their tax reports to the Treasury Department.

Oftentimes companies which are making a lot of money like to reduce the ratio of their earnings by making a liberal depreciation and depletion allowance. Such charges must be made each year and are not cumulative. By the same token, other companies not so prosperous are able to make better income statements if they omit depletion charges. In other words, whether these charges are included in annual statements or not, often depends upon what the management wants to show.

The Investors' Viewpoint

In considering the earnings of mining companies, therefore, the investor should not take the matter of depletion charges too seriously, except in the case of companies whose span of years is definitely indicated and whose end is not far distant. Of such companies there are comparatively few.

In making comparisons of present-day earnings with the pre-war earnings, the investor should include depreciation but disregard depletion charges, except in the case of those few companies which have written off depletion in each year of operations during those two periods.

Oftentimes a company may be earning dividends, though reporting a deficit for the year, if one figures earnings on a pre-war basis. In short, the tax-born, bookkeeping entry of depletion of mining ores is chiefly employed to save money for the stockholders by keeping down taxes. This practice is entirely legitimate but should not confuse the investor as to the status and earning power of the company in which he is interested.

SCHOOL FOR TRADERS & INVESTORS

(*Continued from page* 764)

stocks that are being sold by weak holders, or by those who must raise cash for emergencies, or by others who think they must sell to avoid ruin. Business is dull, merchants face heavy losses, profits are reduced or have disappeared altogether, purchasing power of both employers and employees is low, and the public is blue. At this stage most ordinary speculators are "broke." This accounts for the fact that they seldom, if ever, buy stocks near the bottom. The banking situation is characterized by a large ratio of deposits and cash to loans, money is a drug on the market and interest rates are low.

Large operators accumulate extensive lines of good stocks while these issues are selling at bargain prices. The general public, on the other hand, having been stung by a recent drastic decline, remains out of the market and nurses its financial injuries.

When accumulation of stocks has proceeded to the satisfaction of large operators, and there is no further advantage to be gained by manipulation for the purpose of shaking stocks out of weak hands, these operators begin their marking-up process. Another reason for gradual recovery of prices is arbitraging between the yield on sound issues and interest on loans. This is done to a considerable extent by banks, in view of low interest rates and abundance of cash. Business confidence begins to revive, unemployment is reduced, and sellers, rather than buyers, begin to fix prices.

The upward swing of security prices is now under way, with bonds in the lead, followed in order by preferred stocks and common stocks. As these various issues rise in price, they are gradually distributed to the public as it begins to take an interest in the procedure. By the time the public in-

(*Please turn to page* 800)

KEEP POSTED

The books, booklets, circulars and special letters listed below have been prepared with the utmost care by investment houses of the highest standing. They will be sent free on request, direct from the issuing house. Ask for them by number.

We urge our readers to take full advantage of this service. Address, Keep Posted Department, Magazine of Wall Street, 42 Broadway, New York City.

BUILD YOUR INCOME ON PROSPERITY'S PATH

This booklet tells you of the wonderful investment opportunities offered by the marvelous growth and prosperity of Miami, Fla. Send for your free copy. (325)

THE FORMULA OF SAFETY

The salient features of this Formula of safety as developed by an old established Bond and Mortgage House, are here set out for investors who would think before, rather than after, placing their funds. Ask for (327)

SAVE MONEY

without sacrificing of safety of principal is the slogan of a well-known bond house specializing in odd lots. Plans and list of opportunities sent to all interested investors. Ask for (329).

FORGING AHEAD IN BUSINESS

This booklet tells in an interesting fashion the facts about the Alexander Hamilton Institute's Course in executive training for business men. Ask for (330).

CHEMISTRY IN INDUSTRY

A remarkable book of 372 pages giving examples of the contributions made to industry by chemistry. Edited by E. H. Howe of the Chemical Foundation, Inc. This book is a symposium to which twenty-one specialists in as many industries, have contributed chapters. The book is sold for $1.00 which merely covers the cost of printing. It will be forwarded to any of our readers who sends one dollar. (334)

INVESTMENT GUIDE

Issued by the oldest first mortgage house in Chicago. It explains how to invest savings at the highest interest rate consistent wits safety. (256)

1925 PUBLIC UTILITY MANUAL

Stone & Webster, Inc., have issued their 1925 Manual giving complete information and statistics regarding the numerous public service companies under their executive management. The statistics include outstanding bonds and capital stocks, dividend periods, population of the territories served by the various companies, annual gross and net earnings, as far back, in some instances, as 1902, balance for reserves, retirements and dividends, and situation with respect to franchises. Ask for (335).

INVESTMENT FEATURES OF COOPERATIVE APARTMENT OWNERSHIP AT JACKSON HEIGHTS

A valuable booklet prepared by the Queensboro Corp., which shows the moderate cost and advantages to be derived from owning your own home in a beautiful section a short distance from New York City. Ask for (336).

(Continued from page 798)

terest is thoroughly aroused, bonds are at the top and beginning to decline, and operators are distributing stocks at a rapid rate. The decline in bond prices is a natural sequel to rising interest rates on money. Stock prices continue to rise, however, owing to rapidly increasing demand on the part of the public which now has surplus funds accumulated from prosperous industries running at full capacity.

Business men now begin to expand their operations and increase the capacity of their plants. Many of them, unfortunately, over-extend their activities with borrowed money, and thus develop conditions for more or less expensive liquidation later on, which may lead in many cases to financial disaster.

Cash holdings of banks decrease while loans increase faster than deposits. Interest rates rise gradually, and the general character of loans becomes inferior, thus increasing the risk of loss.

As bond prices weaken, stock market activity increases, with a rapidly decreasing rate of advance in the average price level in proportion to the greatly increased volume of trading. Wise operators now complete their distribution and convert their holdings into cash. Manipulation now makes the market very active, mostly for the purpose of giving it the appearance of strength in some quarters while further distribution is carried on elsewhere, and all frank reports of a pessimistic nature are suppressed as long as possible. The public is filled up with all the highly speculative common stocks at top prices, as usual. No publicity is given to short selling on the part of large operators who understand the situation and anticipate the decline.

At this time business is generally booming, industries are working overtime, there is a scarcity of labor, and commodity prices have reached high levels. New bond and stock issues are floated on a large scale. The increase in loans is rapid and out of proportion to deposits and cash holdings. Interest rates rise rapidly, and brokers' loans reach record figures, with frequent calling of demand loans, thus forcing the liquidation of stocks carried as collateral.

The average price of stocks now begins to decline, slowly at first, then more rapidly. As more people become aware of the situation, the selling becomes more urgent, until finally everybody wants to sell at the same time, and drastic liquidation is under way. The decline is usually accomplished in about half the time required for the advance. While this is proceeding, business continues to boom and to all superficial appearances there is no change in the situation. This is why most inexperienced speculators, including a large percentage of business and professional men, usually overstay the market and realize the true situation after their profits have been reduced, wiped out, or converted into losses.

At this stage of the cycle, money rates are at record levels and bank loans have passed deposits. Banks call demand loans, brokers call for more margin, speculators liquidate, and credit structure collapses in proportion to its previous over-extension. A period of depression ensues and continues until economic readjustment has run its course; and by that time large operators have reaccumulated their favorite lines of stocks and are waiting for the cycle to repeat.

The sophisticated trader follows the example set by the large operators, and avoids the mistakes made by the uninformed or misinformed public.

INCOME TAX DEPARTMENT

(Continued from page 766)

can be deducted from your other income.

Many Important Ones

Q. (1) Must a dower right in money, and a legacy be included in income? (2) If a corporation or company fails to pay any dividend on money invested in their stock, can that be deducted as a loss? (3) How is the depreciation in value of real estate to be figured? (4) Who are the proper parties to whom to apply for the federal tax blanks? (5) What number of blank would be required by a person with only a small income from money invested and rent from real property, in federal blanks?—E. A.

A. (1) Dower rights and legacies are not taxable as income. (2) No loss can be deducted for the failure of a corporation to pay any dividend. (3) Depreciation on real estate is figured on the cost of the building only as land is not depreciable. The rate of depreciation is determined according to the estimated remaining life of the property at the time of its acquisition. (4) Federal tax blanks can be secured from your local Collector of Internal Revenue. State tax blanks can be secured from the taxing official of the State. (5) The federal blank that would be required in the case described by you, would be Form 1040.

Straus Bonds

Q. I hold a Straus bond which has a tax-free provision in it up to 4%; that is, the Straus Company pays 2% at the source and refunds the other 2% to me. How shall I treat this in my return?—J. A.

A. The 2% refunded to you should be reported by you as additional interest. You can take as a credit against the tax due by you, the 2% that has already been paid at the source for you.